Ideas & trends

From nuggets to dross: The false gleam

The gold standard is being actively promoted these days by a group of true believers who combine fervent belief in their positions with well-honed communications skills and a wild use of facts, analogies, and free-for-all conclusions. Besides debasing American economic policy, they are downgrading public discourse.

The gold standard, they tell us, would limit the ability of the government to print money; hence, they argue, prices would be stable, and inflation would end "immediately," to use the favorite adverb of Jude Wanniski, president of his own economic consulting firm and a leading true believer in the gold standard (BW - Dec. 7).

Americans, especially in times of distress, love miracle cures and public policies simple enough to be summed up on car bumper stickers. This is just one more reason to be wary of those who promote the gold standard. There is no reason to expect that they will run into heavy public opposition.

The advocates of the gold standard lead off with the historical argument which holds that prices were stable when the U.S. was on the gold standard. Lewis E. Lehrman, a leading gold advocate, a member of the U.S. Gold Commission, and candidate for governor of New York State, says: "The gold standard in one form or another gave us reasonable price stability from 1792 until 1971, except for some periods, such as the Civil War and the Great Depression."

Misreading history. I do not believe historical facts are admissible evidence without an analysis of their context and a systematic examination of the differences between their times and ours; the conditions under which a policy worked in the past often do not exist today. However, promoters of the gold standard are doing much worse than the facile forward projection of historical facts; the "historical precedents" they cite never took place. Prices were not stable during the periods referred to. This has been documented by economist Edward Bernstein, among others, who concluded flatly: "The view that the gold standard provided the discipline necessary for monetary stability is an illusion."

According to Bernstein, wholesale prices in the U.S. fell 60% from 1815 to 1843, rose 15% from 1843 to 1864 (largely because of the Civil War), and dropped 49% from 1872 to 1896. Succeeding periods saw similar fluctuations in prices. From 1896 to 1913, wholesale prices rose 50%; from 1922 to 1932, they dropped 33%. The fluctuations are even more pronounced if World War I is taken into account.

Beyond their loose play with historical facts, the gold advocates' preoccupation with one outcome—stable prices—highlights the simplistic nature of their argument. They argue that stable prices will solve every problem but cleaning the kitchen sink because once the dollar is "sound" again, people will save more and invest more, foreigners will hasten to convert their funds into dollars, and all sorts of other benefits will start to flow.

The money squeeze. Gold advocates ignore a little detail known as economic growth. As population growth, capital accumulation, and technological developments take place, the economy can yield more. At the same time gold production often grows more slowly as the easily mined veins are exhausted and governments slow down production to drive up the price. The result is a money corset. Under a gold standard, if the price of gold remains fixed (as it must if it is to stop inflation), the money supply may well grow so slowly that it will choke off economic growth. This happened several times between 1815 and 1914; the U.S. underwent a series of "panics" (12 in all) in which masses of people were thrown out of work and the economy yielded much less than its capacity because the increased demand for currency and credit could not be matched by an expanding gold standard.

True, history is not always a reliable guide for the future, but clearly there is something here worth worrying about. We should not disregard price stability, but there are more goals than one in a viable economic policy.

Sometimes, the use of historical facts by the knights of gold is subtle, indeed. The champion supply-side economist, Arthur B. Laffer, and his associate, Charles Kadlec, write: "Throughout America's history, when the link between the dollar and gold is severed, inflation appears. And when the link is restored, price stability ensues."

If you read this very carefully, Laffer and Kadlec do not say that inflation prevailed or continued in all, more, or even many of the years when the gold standard was not in use; nor do they say that it was absent during all, most, or many of the years when a gold standard was employed. They state only that the institution or abandonment of a gold standard had an effect at the time the action was taken. However, the issue is not whether gold will prevent inflation in the year the link is actually restored, but whether it will do so in the years that follow. And any normal reader will read the Laffer-Kadlec text as implying continuing effectiveness.

The gold advocates' response to frequently raised objections matches their historical precision. Critics of the gold standard have pointed out time and time again that, other than the U.S., the main producers of gold are South Africa and the Soviet Union. Once the American government makes the supply of money dependent on the size of its gold stock, and thus gives up the levers to manage the country's money supply, those two governments would take over its management and with it the power to affect the level of our economic activity. If either country were to hold back its gold or suddenly release its supply on the world markets, its action would deflate or inflate...
of a gold standard

the American money supply and, through it, American economic activity.

What answer do the gold brigade's members offer for this problem? Most often, they ignore it, as if they did not hear the question, and talk instead about reinstating "honest dollars" or dollars that are worth more than the current adjusted-for-inflation, 15¢-a-dollar "paper money." Lehman, who does respond, argues that because there are large amounts of gold in private and official vaults, even if "the Soviet Union and South Africa could sell off all of their production in a single instant, this would constitute no more than 1% of total gold stocks." But this confuses annual production with total stock, which is like comparing rainfall with the water already in the oceans. An unfriendly government might not be able to change the world's gold stock, but it still could shower us with demands to buy gold (and hence issue money and inflate the economy) or achieve the opposite effect by refusing to sell gold, in either case at its discretion.

Another glittering analysis of the international scene is offered by Wanniski. He argues that "if President Reagan were to announce a reopening of the gold window—with universal convertibility—in 24 hours all major nations would be forced to follow suit." The line reminds me of the answer Laffer used to give when asked how quickly supply-side tax cuts would deliver the promised bonanza: "How long does it take you to pick up a $100 bill?" These days President Reagan says instead that "the train is a bit late in leaving the station." In the case of gold, there is good reason to believe this particular train is going nowhere. To suggest that the Soviet Union will react to anything in 24 hours is to reveal astounding ignorance about how its bureaucratic government works. And it is difficult to imagine the Soviets joining South Africa and the West to set up a stable monetary system to save us from inflation, whether in 24 hours, days, months, or years.

Freasing the economy. There is an element of the golden argument that is difficult to resist completely. Gold's fervent advocates wish to lock the economy onto an automatic pilot and throw away the key. They contend that deliberate management of the economy has had miserable effects, as indeed it has. With a fixed dollar value in gold, the government would no longer be able to stimulate the economy during recessions or deflate it when it overheats. Instead, the money supply would be subject to forces the government cannot control, such as the amount of gold mined each year. We would be saved from our own folly.

The trouble with this line of thinking is that, in fact, there is no way of throwing away the key to the economy. Initial midcourse corrections would have to be made, to get the "right" gold-dollar ratio; after that, the government could go on and off the gold standard as it deemed fit. Moreover, as study of price fluctuations under the gold standard shows, the "automatic" part of the trip would be far from smooth.

Finally, of all the sleight-of-hand arguments from gold standard proponents, the prizewinner is the suggestion that if supply-side economics fails, it will be because the gold standard was not adopted. If this is not simply an after-the-fact alibi, the supply sides should have made it clear to President Reagan, as he was celebrating victory after his struggle with Congress, that his economic recovery program was about to take off into the blue yonder with neither airplane nor parachute.

Chances of adoption. All the serious economists I know think that a return to the gold standard is an idiotic idea. Few of them have said so for the record, though Yale economist William Nordhaus titled a forget-gold statement "The Year of the Quack." Most of the economists believe the idea does not have a real chance to become public policy, so why fight it? They are overlooking the tendency of governments, when their prevailing policy openly fails, to grasp at any straw. (Who would have thought President Nixon would resort to wage and price controls?) That President Reagan and several of his close associates, such as Senator Paul Laxalt (R-Nev.), believe in the gold standard certainly does not shut the lid tight on Fort Knox.

The Presidential Gold Commission was set up partly to defuse right-wing pressure in favor of the gold standard, and more of its members are opposed to or neutral about the idea than support it. Still, the very existence of the commission gives the idea an aura of legitimacy, making it seem a viable rational option. One cannot ignore the fact that the idea is also championed by many of the same crew—from Wanniski to Laffer—who gave us supply-side economics. Though some label them the high priests of voodoo economics, they have enjoyed the ultimate compliment, seeing their concoctions become the brew of national policy.

The best response to the gold nuts is to evolve an economic policy that makes sense and that works. Until that is done, the door will be open to peddlers of all kinds of snake oil. Meanwhile, while the rest of us try to survive a recession that promises to be anything but "slight," it is incumbent on those who can think straight to ensure that the gold standard is not seen not as a policy option that reasonable people might consider. Otherwise, we may have to await David Stockman's next confession to find out that while the country was being subjected to one more bizarre experiment in economic witchcraft, Donald Regan, Weinbaum, and Paul Volcker knew that the call for a gold standard, like supply-side economics, was a nutty idea, but chose not to speak out.
Professor Amitai Etzioni discloses himself adroit at phrasemaking but careless with the facts in his attack on gold standard advocates in “The false gleam of a gold standard” (Ideas & trends, Feb. 8). Like most proponents of the present monetary system, he didn’t mention the abysmal record of the past 10 years since the U.S. broke its ties with gold. First, he contends that a gold standard is a supply rule.... But he misrepresents a classical gold standard. A gold standard is not a supply rule. It is a price rule, which means that monetary policy is aimed at stabilizing the value of the currency, not its supply.

Insofar as the required gold supplies are concerned, a gold standard can be administered with a small amount of gold, as was the British system which functioned well for 200 years. While the statistics offered by Etzioni have questionable relevance to today’s economy, they do show that U.S. experience with a gold standard provided far more price-level stability than we have experienced in several years.

Etzioni’s misrepresentation of the gold standard is compounded in his expressed fears that gold suppliers or holders of large dollar portfolios could disrupt a gold standard. It is the inflexible mandate, supply rule that poses the greatest danger should the world’s demand for dollars shift. A price rule/gold standard would allow the quantity of dollars in circulation to shift with demand.

In sum, Etzioni’s comments tell us more, I think, about the tenuous foundations of the present shaky monetary system than about the merits of a new gold standard. The subject deserves better treatment than he, an academician, was willing to give it.